How Private Governance Made the Modern World Possible

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What makes markets, and especially advanced contracts, possible? Most social scientists, including a high percentage of libertarian ones, describe the world as fraught with prisoners' dilemmas (the idea that collaborators would be better off working together, but they each have an incentive to cheat) that can only be solved by government. For example, Israel Kirzner suggests that markets need "governmental, extra-market enforcement" stating that that without "enforceability of contract… the market cannot operate." Similarly Mancur Olson states that without "institutions that enforce contracts impartially" a society will "lose most of the gains from transactions (like those in the capital market) that require impartial third-party enforcement."[1]

But in many cases government officials do not have the knowledge, incentive or ability to enforce contracts or property rights in a low cost way.[2] Consider parties contracting in third world countries where trials take more than a decade. Or consider parties in the first world making a contract where time is of the essence or a lot of money is at stake. Who wants to get large resources tied up in a trial that can take months or years? Or consider making a low value exchange where the cost of going to trial vastly exceeds the value of a transaction. Or consider making a transaction across political boundaries which makes establishing jurisdiction for a trial difficult. At a minimum using courts or government law enforcers requires time and resources, and as practical matter entire classes of contracts are effectively unenforceable.

Judges, police, and regulators are a deus ex machina. Government is often dysfunctional and crowds out private sources of order, or it is simply absent or too costly to use. That means parties can either live with their problems or attempt to solve them. In some cases solutions have yet to be found or are too difficult to implement. Such is the world. But quite often solving problems is a profit opportunity and the more at stake, the more potentially profitable the solutions. Throughout history we can see lots of examples of private parties benefiting by figuring out better ways of facilitating exchange or protecting property rights. These protections of the market come not from government but from the market.

In his theory of clubs, James Buchanan argued that we should not assume that goods either must be private goods for one person or public goods for everyone in society, but instead a high percentage of goods are club goods that fall somewhere in between.[3] One of the most important but underappreciated types of club goods is private governance, the various forms of private enforcement, self-governance, or self-regulation among private groups or individuals that fill a void that government enforcement cannot. A country club or a night club not only provide a physical space for leisure, but they also have rules of entry and conduct. The same is true of places of business or living like shopping malls, apartment complexes, stock exchanges, and financial intermediaries. eBay, for example, is a club that facilitates trade with reputation mechanisms and dispute resolution services. It evaluates the marginal benefits and marginal costs of having various rules or dispute resolution mechanisms and seeks to make its market as attractive as possible. American Express is another type of club that helps ensure that consumers get what they pay for and merchants get paid. Most people don't think of their credit card as a rule enforcing club, but it is. A merchant that overcharges customers or a customer who does not pay his bills gets kicked out of the club and that encourages honest behavior.

Private governance helps protect property rights and facilitate trade in everything from the simplest to the world's most advanced markets. It operates in markets where government theoretically can enforce contracts and where government explicitly refuses to enforce contracts. Let us consider some examples.

In all of the world's first major stock markets, government officials considered much of the trading as a form of gambling or speculation used to manipulate prices. In the first stock market in seventeenth century

Amsterdam, government refused to enforce all but the simplest securities contracts. After the founding of the Dutch East India Company in 1602 a secondary market for shares emerged among brokers who began specializing in trading stocks. Officials soon passed edicts outlawing their nascent market, but stockbrokers continued trading and developed many sophisticated transactions including forward contracts, short sales, and options. How is that possible? Instead of formal rules, stockbrokers relied on reciprocity and reputation mechanisms to encourage contractual compliance. In contrast to the one shot prisoners' dilemma story, most business is repeated and brokers had to be reliable if they wanted others to do business with them. Not only would a defaulter sour his relationship with his trading partner, but he would be boycotted by everyone else who found out. Reputation thus served as a substitute to formal rules. The market was wildly successful and helped finance the Dutch Golden Age. Some estimates put the market capitalization of the Dutch East India Company in current dollars at $7 trillion. Modern New Yorkers can thank the Dutch East India Company for financing Henry Hudson's first voyage to New York's North River (the Hudson River) and the Dutch West India Company for founding New Amsterdam (New York).[4]

The stock market in England had many similarities. In eighteenth century London officials banned stockbrokers from the Royal Exchange and also refused to enforce most contracts. The market persisted anyway with brokers meeting in coffeehouses around Change Alley. Adam Smith described how time bargains (forward contracts) were unenforceable but people made them and abided by them anyway. He stated, "A dealer is afraid of losing his character, and is scrupulous in observing every engagement. When a person makes 20 contracts in a day, he cannot gain so much by endeavouring to impose on his neighbours, as the very appearance of a cheat would make him lose." If someone defaulted, brokers would label them a lame duck and brokers eventually began writing the names of defaulters on a blackboard. Later brokers decided to transform Jonathan's Coffeehouse into a private club that could create and enforce rules. The club, later known as New Jonathan's, The Stock Subscription Room, and then The Exchange or The Stock Exchange, had membership requirements and rules for dealing with default. They adopted as their motto "My word is my bond."

One can see a similar history in New York about a century later. Early stockbrokers met in the Tontine Tavern and Coffeehouse which in 1797 adopted a "Constitution And Nominations of the Subscribers." In 1817 others founded the New York Stock and Exchange Board, i.e. the New York Stock Exchange, which had more formal membership requirements and rules. Brokers added different resolutions over the years, and by the 1860s, in addition to blacklisting those who did not follow through with their contracts, to make sure everyone was proper they had rules prohibiting "indecorous language" (suspension for a week), fines for "smoking in the Board-room, or in the ante-rooms" (five dollars), and fines for "standing on tables or chairs" (one dollar). By 1865 the initiation fee was $3,000 and by 1868 one's membership seat became a valuable property right that could be sold to potential members. They also created listing requirements for firms that wanted to be traded on the "big board." The New York Stock Exchange always had to compete for business and throughout the years faced competition from the Open Board of Brokers (merged with the New York Stock Exchange in 1869, the Curb Market and its more formal outgrowth, the New York Curb Exchange (founded in 1921 and renamed the American Stock Exchange in 1953), the Consolidated Stock Exchange of New York (founded in the 1880s), and regional exchanges including the Boston Exchange and Philadelphia Stock Exchange (founded in 1834 and 1754, respectively, the latter in London Coffee House). By creating a set of rules to make stock markets more attractive to investors, they helped finance the growth of American business.

In modern times the largest and most advanced markets are also backed by private governance. Consider derivatives contracts, some of which can entail unlimited downside risk and even the best legal system cannot recover an infinite amount. Even the notional value of contracts traded through the Chicago Mercantile Exchange, Chicago Board of Trade and the New York Mercantile Exchange exceeds $10 trillion per year, the contracts go without a hitch. When two parties make a trade through these exchanges, they

are not actually making a contract with each other but making separate contracts with the futures exchange. The futures exchange acts as an intermediary and assumes and manages risks for its customers. Rather than allowing any contract to occur and then attempting to enforce it ex post, they have various rules and margin requirements that specify what trades can be made. The risk management from these exchanges eliminates the “need” to have any of these contracts enforced in court.

Other financial intermediaries also assume and manage risks on behalf of customers. When doing business with PayPal or with most credit cards, if fraudsters make bogus transactions or attempt to takes money out of an account PayPal is on the hook. By 2001 fraudsters were stealing more $10 million from PayPal per month at a time when its gross annual revenue per year was only $14 million. At first PayPal contacted the FBI and found that it was of little help. After seeing the evidence, the FBI asked questions such as “What’s a banner ad?” These government officials were not at the forefront of technology, but even if they were, they still would have been powerless against anonymous fraudsters on the other side of the globe. Rather than sitting around and hoping that government would solve the problems, PayPal came up with private solutions to deal with fraud before it occurred. They developed human-assisted artificial intelligence to monitor accounts, search for suspicious activity, and temporarily or permanently suspend accounts. By assuming and managing risks on behalf of customers, PayPal transformed what many people assume must be legal questions into risk management questions. When parties can deal with problems ex ante, ex post contract enforcement is not the “necessity” that theorists like Kirzner or Olson assume.

Private governance is responsible for creating order not just in basic markets but also in the world’s most sophisticated markets, including stock markets, futures markets, and electronic commerce. The role of private governance in enabling stock markets and modern capitalism is one of the least known but most important achievements in the history of the world. Private governance also protects contracts and property rights in scores of other markets. Private governance can be found working in ancient and modern societies, in small and large groups, among friends and strangers, and for simple and extremely complex transactions. It often exists alongside, and in many cases in spite of, government legal efforts. I document more examples in my book *Private Governance: Creating Order in Economic and Social Life* published by Oxford University Press.

Friedrich Hayek used the word “marvel” to describe the price system and its role in coordinating disparate individuals.[5] The mechanisms of private governance are just as miraculous and responsible for creating order in markets. As Thomas Paine writes:

> Great part of that order which reigns among mankind is not the effect of government. It has its origin in the principles of society and the natural constitution of man. It existed prior to government, and would exist if the formality of government was abolished. The mutual dependence and reciprocal interest which man has upon man, and all the parts of civilised community upon each other, create that great chain of connection which holds it together.[6]

The invisible hand analogy in economics sheds light on underappreciated processes of coordinating behavior, and the study of private governance sheds light on similarly underappreciated mechanisms for creating order. Private governance works behind the scenes so most people miss it, but it makes the modern world possible.

[1] Kirzner, Israel M. 2000. *The Driving Force of the Market: Essays in Austrian Economics*. New York: Routledge, p.83. Olson, Mancur. 1996. “Big Bills Left on the Sidewalk: Why Some Nations Are Rich, and Others Poor.” *Journal of Economic Perspectives*, 10(2): 3-24, p.22.

[2] Galanter and Williamson label the common worldview that all cooperation and trade depend on third party enforcement as legal centralism. Galanter, Marc 1981. "Justice in Many Rooms: Courts, Private Ordering, and Indigenous Law." *Journal of Legal Pluralism*, 19: 1-47. Williamson, Oliver E. 1983. "Credible Commitments: Using Hostages to Support Exchange." *American Economic Review*, 73(4): 519-40.

[3] Buchanan, James M. 1965. "An Economic Theory of Clubs." *Economica*, 32: 1-14.

[4] These paragraphs draw from my research in my book: Edward Stringham. 2015. *Private Governance: Creating Order in Economic and Social Life*. New York and Oxford: Oxford University Press

[5] Hayek, Friedrich A. 1945. "The Use of Knowledge in Society." *American Economic Review*, 35(4): 519-30.